TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Governor's Budget Proposal on State Contributions to CalSTRS

ITEM NUMBER: 2

ATTACHMENT(S): 2

ACTION: X

MEETING DATE: January 23, 2003

INFORMATION: ___

PRESENTER: Ed Derman

On December 2, the Governor proposed a series of General Fund reductions and other adjustments to reduce General Fund liabilities by $10.2 billion through the end of the 2003-04 fiscal year, to address what has subsequently been identified as a $34.6 billion General Fund shortfall over that period. These proposals would require the enactment of legislation to implement. One of the proposals would affect the funding of purchasing power maintenance benefits provided by the California State Teacher's Retirement System (CalSTRS).

MAINTAINING THE PURCHASING POWER OF CALSTRS BENEFITS

Although Defined Benefit (DB) Program members and beneficiaries receive an annual adjustment in their benefits, equal to two percent of the initial benefit, they also experience erosion in the purchasing power of their initial benefit due to inflation. Under current law, when the benefit currently being paid is less than 80 percent of the purchasing power of the initial benefit, CalSTRS pays a supplemental benefit on a quarterly basis to that person, to restore the total benefit paid by CalSTRS to 80 percent of the purchasing power of the initial benefit. For example, if a CalSTRS member received an initial $6,000 benefit annually in 1970, CalSTRS would now be paying her $9,840 per year as a result of the annual two percent benefit adjustments. She would, however, have to receive $29,430 in 2002 to be fully compensated for the effects of inflation on the benefit. In order to receive a benefit equal in purchasing power to 80 percent of the initial purchasing power, she would have to receive a total of $23,544 per year (80 percent of $29,430). Consequently, CalSTRS would pay a supplemental benefit equal to the difference between the $23,544 she would need to maintain 80 percent of the purchasing power of the initial benefit and the $9,840 she is actually receiving, or $13,704. This amount would be paid in four equal installments annually, or $3,426 per quarter.

The quarterly supplemental payment is paid primarily from the Supplemental Benefit Maintenance Account (SBMA), a special account of the Teachers' Retirement Fund. (A small percentage of the benefit is paid from payments received by the state for the use of school lands, but these payments are not affected by the Governor's proposal.) The SBMA is funded from an annual statutory appropriation from the General Fund as a result of Section 22954 of the Education Code, "pursuant to a contractually enforceable promise to make annual contributions from the General Fund to the Supplemental Benefit Maintenance Account". Under current law, in 2003-04, that appropriation would be equal to 2.5 percent of the creditable compensation paid to members during 2001-02, or a total of about $555 million. That appropriation would occur on July 1, 2003.

Funds in the SBMA are credited with interest, based on the actuarially assumed rate of investment earnings of the DB Program. Based on current assumptions adopted by the Board in 2000, therefore, the SBMA is currently credited with eight percent annual interest.

Under current law, members and beneficiaries have a vested right to the full 80 percent purchasing power benefit, if there are sufficient funds in the SBMA to make the full payment. If there are insufficient funds to make the full payment, the Board may:

- Subject to authorization in the Budget Act, increase the employer contribution by up to 0.25 percent annually and credit that increased contribution to the SBMA;
- Reduce the level of purchasing power protection to a level that could be funded with available SBMA funds; or
- Use any actuarial assets in the DB Program in excess of the actuarial obligation of that program to maintain the full purchasing power benefit.

GOVERNOR'S PROPOSAL

In the mid-year budget adjustment, the Governor proposes to reduce the 2003-04 appropriation to the SBMA by $500 million. The proposal also requires the Board, beginning in 2006 and based on an actuarial valuation, to report to the Legislature and the Director of Finance every four years on whether the full 80 percent purchasing power payment could still be maintained through June 30, 2036, despite the loss of the contributions. If the Board determined that the full purchasing power payment could not be maintained through June 30, 2036, then the amount needed to maintain full purchasing power payments, up to $500 million plus the interest that would have been credited to the SBMA if the $500 million had been appropriated in 2003-04, would be transferred to the SBMA on July 30 of the calendar year following the determination by the Board, subject to certification by the Director of Finance. In effect, if the Board determined prior to July 1, 2036, that the loss of $500 million in contributions resulted in its inability to sustain the current program through 2035-36, then, subject to certification by the Director of Finance, the $500 million would be repaid the following year on an actuarial basis. The language of the proposal is in Attachment I.

IMPACT OF THE PROPOSAL ON THE PURCHASING POWER PROGRAM

Based on current assumptions and estimates of future expenditures, CalSTRS staff project that the resources currently in the SBMA, plus the contributions and earnings expected to be made in the future, are sufficient to maintain the full 80 percent purchasing power program through 2039-40, or an additional 37 years. If the 2003-04 contribution was reduced by $500 million, as proposed by the Governor, those resources are projected to be sufficient only though 2034-35, or 32 years. If these projections hold through 2006, then the Board would make a determination at that time that the full purchasing power benefit could not be maintained through 2035-36, and $685 million, based on the current 8 percent interest crediting rate, would be transferred from the General Fund to the SBMA on July 30, 2007.

Although this suggests that the program funded by SBMA would not be adversely affected by this proposal, staff's recent experience with projecting future SBMA expenditures and resources indicates that staff's projections tend to be conservative; that is, the estimate of contributions paid to SBMA tends to be understated and the estimate of expenditures tends to be overstated. This largely reflects higher-than-expected growth in DB Program membership and wages and lower-than-anticipated inflation. (Staff, however, have no reason to question the validity of these assumptions over the long run.) Under current projections, the Board would determine that that the full purchasing power program would be inadequately funded for only one year prior to the repeal of the payback provision in 2035-36. If the current projections prove to be even mildly conservative, then the impact of the Governor's proposal may not result in an inability to fully fund the current purchasing power program until after 2035-36; that is, after the period of time the provision to repay the contributions is applicable. Consequently, if this occurs, the Governor's proposal will result in DB Program members and beneficiaries receiving full purchasing power protection for a shorter period of time than they otherwise would have received such benefits. For that reason, Milliman USA, CalSTRS' consulting actuary, stated in Attachment II that the Governor's proposal was not actuarially sound.

STAFF RECOMMENDATION

Although, under certain circumstances, the Governor's proposal would not affect the long-term funding of CalSTRS' purchasing power program, there is no certainty that the program would not be adversely affected. Under the Board's existing policy, the Board opposes legislation that meet specified criteria, including legislation that:

- Adversely affects the actuarial balance of the funds administered by the System, or result in adverse selection against a retirement plan;
- Deprives members or participants of vested benefits and do not provide equivalent, compensating benefits; or

- Appropriates amounts from the funds administered by CalSTRS for purposes that are not solely in the best interest of the members, participants, or beneficiaries of the retirement plans.

The potential practical effect of the Governor proposal is that all three of these criteria would be met. There is a significant potential that reducing next year's General Fund contribution to the SBMA would reduce the funding available to the program, thereby reducing the length of time that CalSTRS members and beneficiaries would receive vested benefits. CalSTRS consulting actuary confirmed this impact. Affected CalSTRS members, however, would receive no offsetting benefit in return.

Although reducing General Fund contributions by $500 million does benefit other state-funded programs, it does not benefit CalSTRS members as CalSTRS members. As a result, staff recommends the Board oppose the Governor's proposal, in its current form, unless the proposal is amended to, either provide (1) certain repayment, with actuarial interest, of the contributions not paid in 2003-04 or (2) appropriate compensation in the form of increased benefits to affected members, or both.

Admin 2

LEGISLATIVE COUNSEL'S DIGEST

Bill No.

as introduced, ____.

General Subject: Teachers' Retirement System: Supplemental Benefit Maintenance Account.

Under the Teachers' Retirement Law, a continuous appropriation equal to 2.5% of total creditable compensation, as specified, is made from the General Fund for transfer to the Supplemental Benefit Maintenance Account in the Teachers' Retirement Fund to fund purchase power protection payments to retired members of the Defined Benefit Program of the State Teachers' Retirement System.

This bill would decrease that appropriation by $500,000,000 for the 2003-04 fiscal year. The bill would require the Teachers' Retirement Board, beginning in 2006 and every 4 years thereafter, to report to the Legislature and the Director of Finance regarding the ability of the retirement system to pay purchase power protection payments in each fiscal year until 2036 and would appropriate funds, as determined by the actuary and certified by the Director of Finance, as necessary to enable the system to make those payments, as specified, until June 30, 2036. The aggregate amount of funds to be appropriated for these purposes would be limited to $500,000,000, adjusted as specified. The bill would make related Legislative findings.

The bill would declare that it is to take effect immediately as an urgency statute.

Vote: 2/3. Appropriation: yes. Fiscal committee: yes. State-mandated local program: no.

An act to amend Section 22954 of, and to add and repeal Section 22954.1 of, the Education Code, relating to state teachers' retirement, making an appropriation therefor, and declaring the urgency thereof, to take effect immediately.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. (a) The Legislature finds and declares all of the following:

(a) When Chapter 840 of the Statutes of 2001 was enacted, the Legislature intended to provide funding to the Supplemental Benefit Maintenance Account in the Teachers' Retirement Fund to mitigate the possibility that the purchasing power of retired members of the Defined Benefit Program of the State Teachers' Retirement System would be eroded by inflation to less than 80 percent of each member's purchasing power at the time of retirement.

(b) The Supplemental Benefit Maintenance Account in the Teachers' Retirement Fund currently has sufficient funds to provide, through the year 2035, the purchasing power protection contemplated in Chapter 840 of the Statutes of 2001.

(c) The actuary retained by Teachers' Retirement Board provides the board with periodic actuarial valuations of the funds and accounts of the State Teachers' Retirement System, which provide the Teachers' Retirement Board, the Governor, and the Legislature sufficient time to address erosions in the funding status of the system before those erosions have any negative impacts on the intended benefits of the system's retired members.

(d) It is in the best interest of the people of the State of California, in this time of fiscal crisis, to recognize the state's responsibilities as a sovereign state to revise prior commitments, if that revision does not impair the intent and effect of any contractual obligation.

SEC. 2. Section 22954 of the Education Code, as added by Chapter 1021 of the Statutes of 2000, is amended to read:

22954. (a) Notwithstanding Section 13340 of the Government Code, commencing July 1, 2003, a continuous appropriation is hereby annually made from the General Fund to the Controller, pursuant to this section, for transfer to the Supplemental Benefit Maintenance Account in the Teachers' Retirement Fund. ~~The~~

(b) The total amount of the appropriation for each year shall be equal to 2.5 percent of the total of the creditable compensation of the fiscal year ending in the immediately preceding calendar year upon which members' contributions are based for purposes of funding the supplemental payments authorized by Section 24415. However, for the 2003-04 fiscal year only, that appropriation is reduced by five hundred million dollars ($500,000,000).

~~(b)~~

(c) The board may deduct from the annual appropriation made pursuant to this section an amount necessary for the administrative expenses of Section 24415.

~~(c)~~

(d) It is the intent of the Legislature in enacting this section to establish the supplemental payments pursuant to Section 24415 as vested benefits pursuant to a contractually enforceable promise to make annual contributions from the General Fund to the Supplemental Benefit Maintenance Account in the Teachers' Retirement Fund in order to provide a continuous annual source of revenue for the purposes of making the supplemental payments under Section 24415.

~~(d)~~

(e) This section shall become operative on July 1, 2003, if the revenue limit cost-of-living adjustment computed by the Superintendent of Public Instruction for the 2001-02 fiscal year is equal to or greater than 3.5 percent. Otherwise this section shall become operative on July 1, 2004.

SEC. 3. Section 22954.1 is added to the Education Code, to read:

22954.1. (a) Beginning in 2006, and every four years thereafter, the board shall, based on an actuarial valuation approved by the board, report to the Legislature and the Director of Finance regarding the anticipated ability of the system to provide the purchasing power protection contemplated by Chapter 840 of the Statutes of 2001 during each year until June 30, 2036. The actuarial valuation shall take into consideration all expected contributions to the Supplemental Benefit Maintenance Account, expected expenditures from the account, and expected investment returns.

(b) On July 30 of the calendar year following any calendar year in which the board, as a result of the quadrennial valuation required by subdivision (a), reports that the funds in the Supplemental Benefit Maintenance Account will be insufficient in any fiscal year before July 1, 2036, to provide the purchasing power protection contemplated by Chapter 840 of the Statutes of 2001, there is hereby appropriated from the General Fund to the Controller the amount necessary to provide that purchasing power protection, as determined by the actuary, taking into consideration all expected contributions to the Supplemental Benefit Maintenance Account, expected expenditures from the account, and expected investment returns, and subject to the limitation in subdivision (c). The amount appropriated pursuant to this section shall be transferred by the Controller to the Supplemental Benefit

Maintenance Account upon certification of the amount by the Director of Finance.

(c) The aggregate amount of funds appropriated pursuant to subdivision (b) is limited to an amount equal to five hundred million dollars ($500,000,000) adjusted by the actual rate of return on funds in the Supplemental Benefit Maintenance Account from July 1, 2003, after taking into account any amount previously appropriated pursuant to subdivision (b). In calculating this limit, the sum of five hundred million dollars ($500,000,000) shall be treated as an initial principal amount, and this amount shall be adjusted at the end of each fiscal year based on the actual investment return of the Supplemental Benefit Maintenance Account during the preceding fiscal year and shall be reduced by any amounts appropriated pursuant to subdivision (b) as of the date of the transfer.

(d) This section shall become inoperative on July 1, 2036, and, as of January 1, 2037, is repealed, unless a later enacted statute that is enacted before January 1, 2037, deletes or extends the dates on which it becomes inoperative and is repealed.

SEC. 4. This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect. The facts constituting the necessity are:

In order to address the fiscal crisis facing the state in the 2003-04 fiscal year, it is necessary that this act take effect immediately.

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January 14, 2003

via e:mail
Mr. Ed Derman, Deputy CEO
California State Teachers' Retirement System

Re: Proposal for SBMA Funding Alternative

Dear Ed:

At your request, I have reviewed an alternative to the current statutory funding provision for the SBMA. The alternative, as I understand it, does the following:

> *The State's continuous appropriation from the General Fund to the Supplemental Benefit Maintenance Account (SBMA) will be reduced by $500 million for the 2003-04 fiscal year. If, at any time prior to July 1, 2036, the SBMA reserve is estimated to be insufficient to fund the 80% purchasing power benefit through July 1, 2036, the State will make a supplemental contribution up to the value of $500 million plus interest from July 1, 2003. If the SBMA becomes insufficient after July 1, 2036, the State will not be required to make the supplemental contribution.*

We are not attorneys and we are not providing legal advice. We strongly suggest this proposal be thoroughly reviewed by legal counsel.

One of the requirements of the proposal is that the Board's actuary must conclude the proposal is actuarially sound. Upon reviewing the proposal, I have concluded the proposal is not actuarially sound.

An actuarially sound proposal should not cause any diminution of the financial status of the program. My conclusion, strictly from an actuarial point of view, is that the proposal is not sound because the beneficiaries of the SBMA may be left in worse financial position because of the diversion of the $500 million. Of primary concern is the time limit for making up the diverted contribution with interest.

The SBMA reserve is financed solely with State appropriations and is currently expected to be sufficient for decades. However, current projections show the SBMA requiring additional financing sometime prior to 2040 in order to maintain the current level of purchasing power. The projections are necessarily based on actuarial assumptions. Several of the key assumptions include the level of retirement benefits expected to be paid to CalSTRS retirees and beneficiaries, future levels of inflation, and future earnings credited to the SBMA reserve. If future experience emerges less favorably than assumed, the SBMA reserve may be depleted sooner than currently estimated. On the other hand, if experience emerges more favorably than assumed, the SBMA reserve may be sufficient for a longer period.

Current and future estimations of the year in the future when the SBMA reserve may become insufficient to provide the 80% purchasing power payments are dependent on experience and the assumptions. For example, the current long-term inflation assumption is 3.5% per year. If inflation is less than 3.5% for a number of years and all other experience follows the current assumptions, the SBMA reserve will be strengthened. However, an increase in inflation in the future could rapidly deplete the SBMA reserve.

Therefore, it is not unreasonable to conclude that the experience could be neutral or favorable for a long period, and then turn unfavorable over a subsequent period. If the experience turns unfavorable shortly after 2036, the appropriation reduction of $500 million plus earnings could be a significant factor in the availability of purchasing power benefits at that time. Therefore, in my opinion, it is not unreasonable to conclude that the current proposal may result in lower purchasing power payments to future retirees and beneficiaries.

Note that the proposal calls for the actual earnings to be credited to the future supplemental contributions, if any are required. To be clear, the SBMA has historically been credited with the assumed rate of return adopted by the Teachers' Retirement Board in the actuarial valuation of the Defined Benefit Program. As of matter of interest, the value of $500 million with 8% earnings compounded for 33 years is $6.3 billion.

In my opinion, this proposal is not actuarially sound and may lead to a diminution of the financial security of the program and may eventually result in lower purchasing power payments to future retirees and beneficiaries.

If you have any questions, please let me know.

Sincerely,

Mark O. Johnson, F.S.A., M.A.A.A.
Principal and Consulting Actuary